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**COORDINATED ISSUE
MEDIA/COMMUNICATIONS INDUSTRY
CAPITALIZATION OF CABLE TELEVISION FRANCHISE COSTS**

ISSUE

Whether all expenses incurred in obtaining a cable television franchise from a municipality must be capitalized as franchise cost under I.R.C. section 263.

An existing cable television (CATV) company forms a subsidiary to establish a CATV system in a municipality which involves the following expenses:

- Application fees: paid to city
- Marketing and Development
- Travel and Entertainment
- Postage
- Proposal Printing and Graphics
- Educational Seminars
- Slide Shows
- Brochures and Advertising
- Engineering Studies
- Utilities
- Office Supplies
- Telephone and Telegraph
- Salaries and Wages
- Promotion
- Insurance
- Legal and Accounting Fees
- Miscellaneous

The subsidiary capitalizes only the application fees and other fees paid to the municipality as the cost of the franchise under section 263. The subsidiary categorizes all the remaining expenses as section 195 start-up costs and elects to amortize the expenses over 60 months.

SERVICE POSITION:

All expenses related to the awarding of a cable television franchise must be capitalized and constitute the cost basis of the franchise. Such expenses do not qualify as start up expenses under section 195.

RATIONALE:

All the expenses are capital expenditures under IRC section 263 and constitute the cost bases of the franchise under IRC section 1012. See Rev Rul. 56-520, 1956-2 C.B. 170 (expenses incurred in obtaining FCC broadcast license); Rev. Rul. 56-600, 1956-2 C.B. 171 amplified by Rev. Rul 67-113, 1967-1 C.B. 55 (expenses incurred in obtaining certificate to service new air routes from Civil Aeronautics Board); Rev. Rul. 86-71, 1986-1 C.B. 102 (expenses incurred in obtaining FCC broadcast license). Thus, the expenses are not currently deductible or amortizable under section 195.

Section 263(a) disallows deductions for expenses incurred in the acquisition, creation or improvement of tangible and intangible assets with useful lives in excess of one year. See Rev. Rul. 83-66, 1983-1 C.B. 43. In defining the broad scope of section 263, the Supreme Court stated:

The purpose of section 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.

Commissioner v. Idaho Power Company 418 U.S. 1, 16 (1973). The Supreme Court also stated in Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 354 (1971):

The presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective benefit beyond the taxable year.

What is important and controlling, we feel, is that the ...payment serves to create or enhance... what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in and not an expense, let alone an ordinary expense, deductible under section 162(a)...

The rationale for requiring that such expenses be "capitalized" under section 263, and added to the assets cost basis under section 1012, was explained in Idaho Power. In that case, the Supreme Court held that the depreciation of vehicles, used in the construction of a building, could not be taken as a current deduction, but must be added to the basis of the building. The Court stated:

When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of

income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost although certainly presently incurred, is related to the future and is appropriately allocated as a part of the cost of acquiring an income producing capital asset.

Idaho Power, 418 U.S. at 11. Later the Court stated: "...This capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to an asset acquisition were deducted from gross income currently realized.." Id. at 14. See also Mertens, The Law of Federal Income Taxation paragraphs 25.34 and 25.55 (1988).

None of the expenses noted above are start-up costs under section 195 because the expenses do not meet the definition of start-up expenditures contained in section 195(c)(1). Section 195 applies to expenses incurred in investigating the acquisition or creation of a trade or business or incurred in creating a trade or business. Section 195(c)(1)(B).

The expenses at issue here are not section 162 expenses, but are incurred in obtaining the CATV franchise, which is a separate and distinct asset, with a useful life in excess of one year. The expenses at issue are not currently deductible, whether paid or incurred by a new business or an existing business. Thus, section 195 does not apply.

Courts have held that expenses incurred in acquiring a broadcast license from the Federal Communications Commission (FCC) must be capitalized. In Dustin v. Commissioner, 53 T.C. 491 (1969), aff'd, 467 F. 2d 47 (9th Cir. 1972), the Tax Court held, and the Ninth Circuit affirmed, that legal, engineering and accounting fees incurred in connection with the awarding of an FCC broadcast license, must be capitalized. 35 T.C. 7 (1960), 299 F.2d 614 (8th Cir. 1960), See also KWTX Broadcasting Company Inc. v. Commissioner, 31 T.C. 952 (1959); WHEC, Inc. v. Commissioner, 37 T.C. 821 (1962).

Courts have also held that incidental expenses, incurred in the construction of tangible property, must be capitalized. As stated above, in Idaho Power the Supreme Court held that depreciation on vehicles used in the construction of building must be capitalized. In Louisville and Nashville Railroad Company v. Commissioner, 66 T.C. 962 (1976) the Tax Court held that overhead expenses, including indirect labor costs, utilities and repair costs, incident to construction, must be capitalized.

The rule in these cases is that all expenses incurred in connection with the creation of a separate and distinct asset with a useful life in excess of one year must be capitalized. The awarding of a CATV franchise cannot be distinguished from the above cases, and thus, the expenses at issue must be capitalized.

CONCLUSION:

The cost basis of a CATV franchise includes all expenses related to the awarding of the franchise. Such expenses must be capitalized as franchise costs. Therefore, they are not currently deductible: nor are they amortizable as start-up costs under section 195.